# IV. EFFECTS OF REFORMS ON INSURANCE RATES

This section will analyze how the reforms have been reflected in the rates charged by insurers in relation to the rates approved by the CDI.

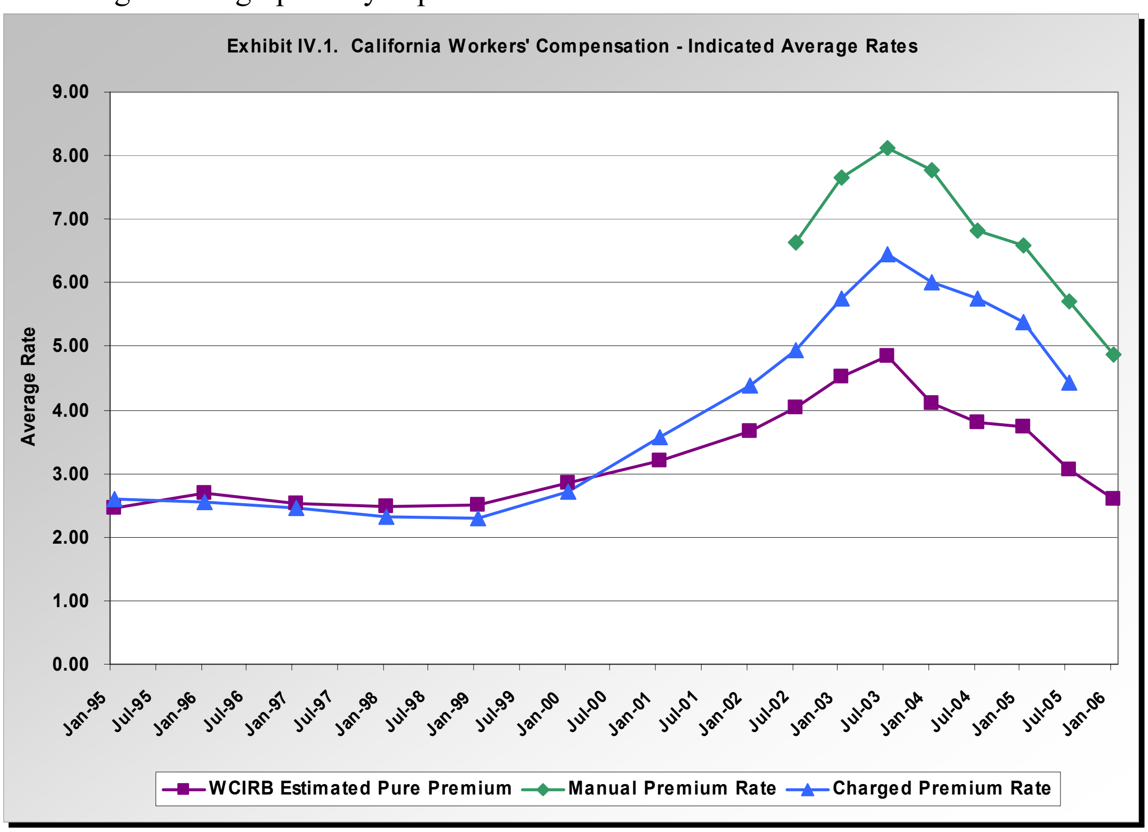
***Overview***

The following are our general observations regarding the relationship between CDI approved rates, insurance company manual rates, and insurance company charged rates:

- After the recent major reforms (the first of which incepted on January 2003), the approved rates, manual rates and charged rates have moved in generally the same direction. However, the CDI approved rates have decreased faster than manual and charged rates.

- In the late 1990's, the full premium rates charged by insurers were about the same as the CDI approved pure premium rates. Since pure premium rates only reflect loss and loss adjustment expense, the charged premiums did provide adequate money for other expenses, such as overhead and agent/brokerage fees. Insurance carrier charged rates are now higher than the CDI pure premium rates, but below manual premium rates.

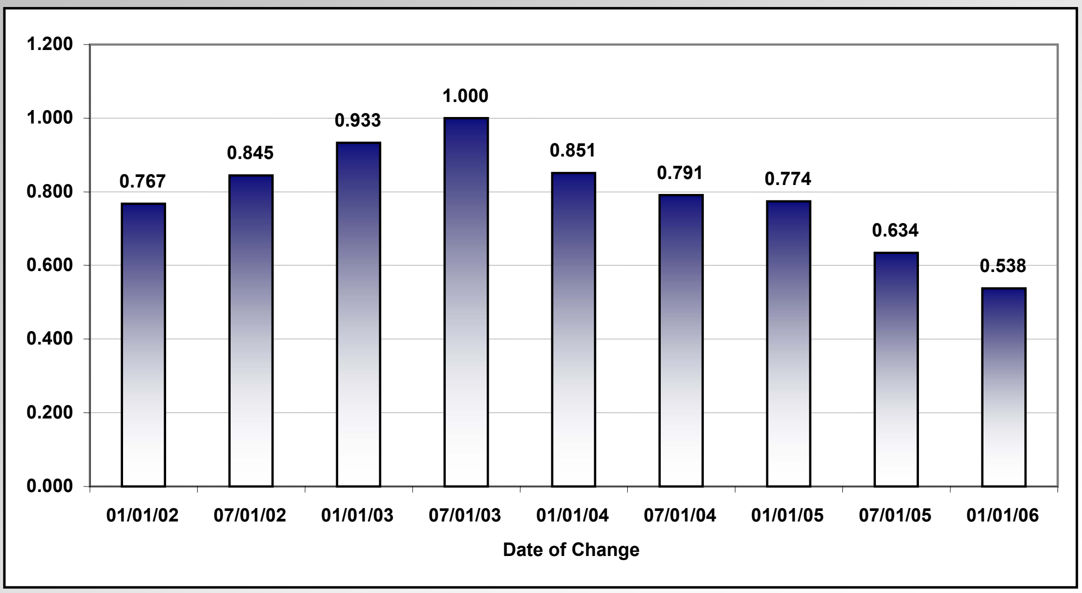
The following exhibit graphically depicts these observations.



*Company Premium Levels*

Premium cost levels for workers' compensation coverage in California have dropped dramatically over the last two years. The declines have occurred in marked contrast to the pre-reform period during which the average pure premium levels approved by the CDI increased steadily for several consecutive years. Approved pure premiums reached a high point on July 1, 2003. The increases were adopted in response to continuous growth in perceived loss cost levels. The long term trend changed in 2004, reflecting the anticipated impact of the reforms. A summary of approved pure premium levels for recent years in relation to the July 2003 high-point is presented in the exhibit below:

**Exhibit IV.2. CDI Approved Pure Premium Level as a Ratio to July 1, 2003**

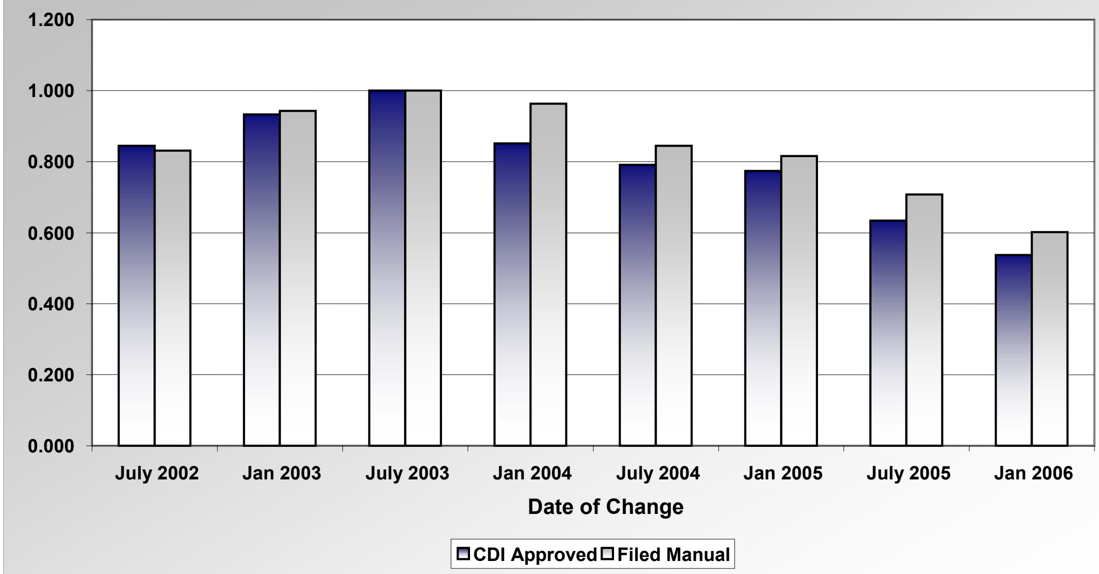



*Source: WCIRB California*

In the above chart, the 0.634 figure for July 1, 2005, indicates that approved pure premium rates decreased by approximately 36.6% (.366 = 1.000 – 0.634) from July 1, 2003 to July 1, 2005. With the January 2006 change, the aggregate reduction now exceeds 46%.

Insurance carriers have responded to the recent decreases in anticipated workers' compensation costs with reductions in filed manual premium rates.

**Exhibit IV.3. CDI Approved and Insurance Filed Pure Premium Levels as a Ratio to July 1, 2003**




*Source: California Insurance Department Rate Filings – Summarized by Perry & Knight*

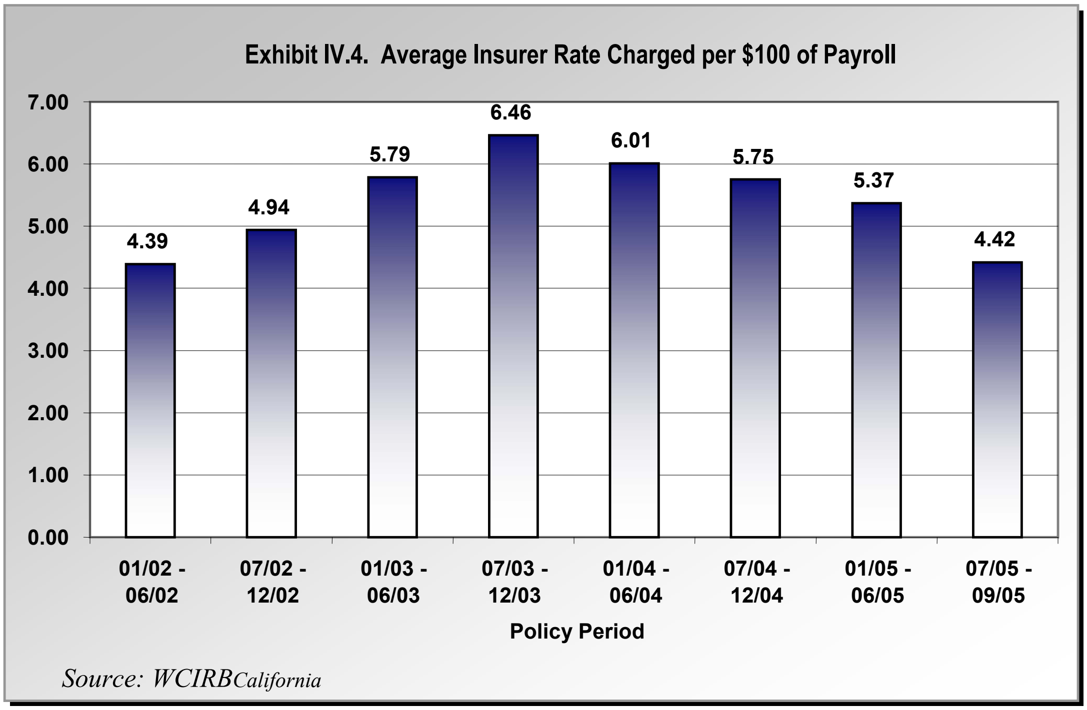
The final premium rates charged by insurance companies may differ from the rates on file with the CDI. The differences can be attributed to a variety of factors, including:

- The filed rates reflect manual premium levels. Such rates are subsequently modified by the experience rating program for application to individual employers. The experience rating program, which is maintained by the WCIRB, is designed to measure the degree to which an individual account can be expected to be either better or worse than the average for the class(s) to which it is assigned. The experience rating program is a formula driven rating plan that will generate a uniform adjustment for a particular account, regardless of which carrier ultimately provides coverage.

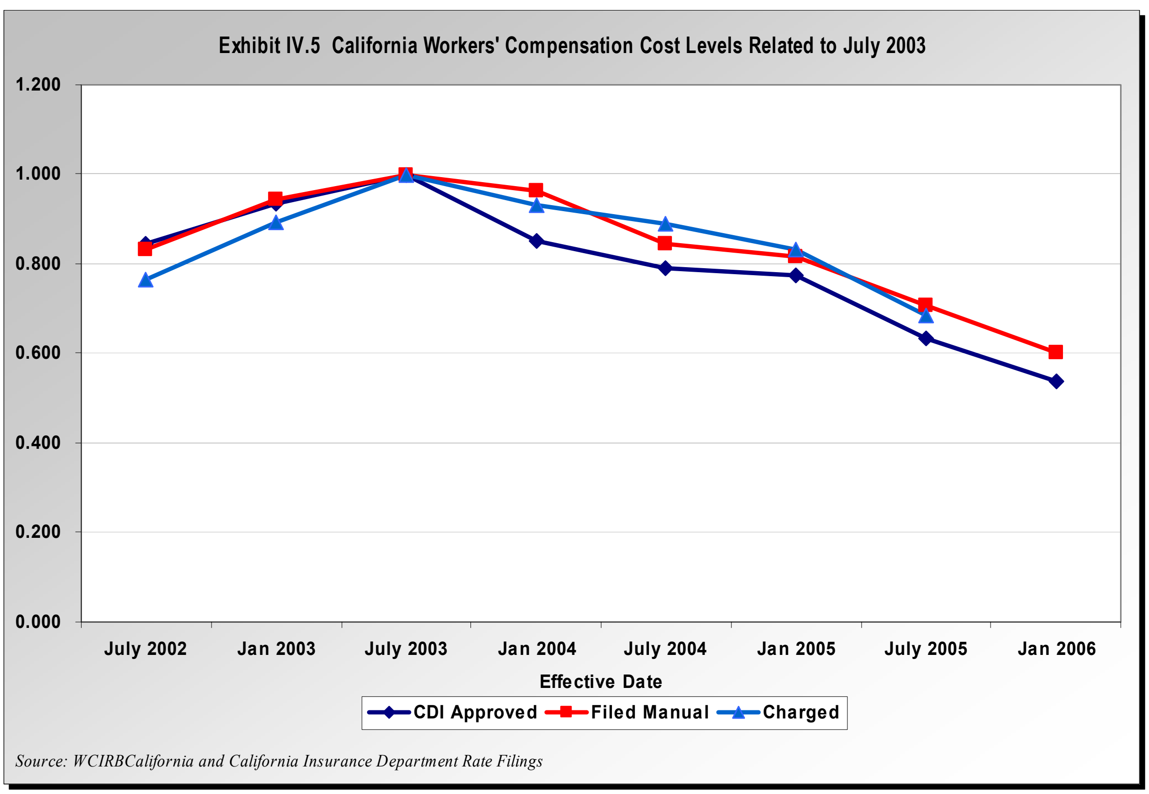
- Insurance companies have the option to modify the indicated rates further through application of schedule rating plans. Unlike the experience rating plan, schedule adjustments applied to individual employers will likely vary among insurers.

- Charged premiums can also vary from one year to the next due to changes in expense provisions and investment income assumptions.

Data published by the WCIRB suggests that actual charged rates have declined steadily since July 2003. The following exhibit shows that the average premium rates charged in the third quarter of 2005 are roughly 31.6% lower than those from the second half of 2003 ($6.46 rate during the second half of 2003, $4.42 during the third quarter of 2005). This drop is reasonably consistent with the 36.6% decline in approved pure premium levels during the same period.




The exhibit below presents a comparison of changes in charged premium rates with changes in approved pure premium levels.




WCIRB data indicates that charged premium levels tended to move in conjunction with changes in approved pure premium levels. We also note that there is a degree of symmetry to the graph;

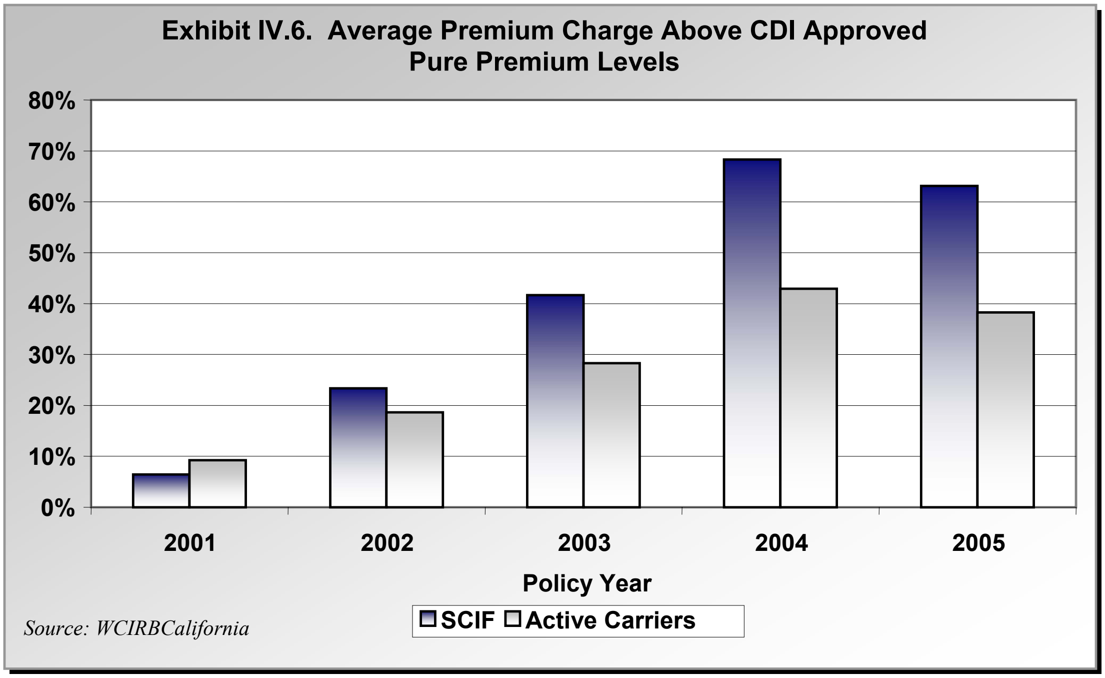
carrier action tended to lag that of the pure premium rates, both when rates were increasing and also when rates started to decrease.

We believe that there are a number of reasons that carrier rate level action has not changed as quickly as the CDI approved pure premiums.

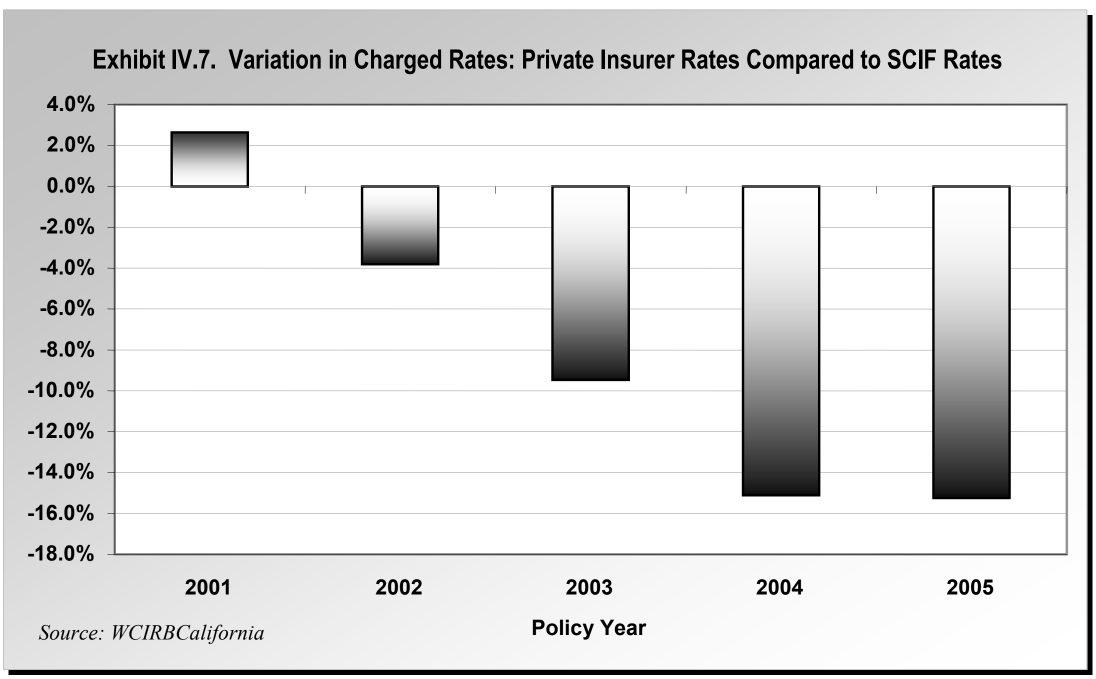
- Workers' compensation coverage needs to be priced in advance. Insurers, many of which incurred significant losses resulting from the continuous deterioration in underwriting results during the period leading up to the reforms, may be hesitant to rely fully on preliminary data when making premium level decisions reflecting the potential impact of the reforms.
- There may be a reluctance to commit to premium decreases when uncertainty persists regarding the ultimate status of reforms.
- There is commonly a lag in response that can be tied to the time needed to evaluate the degree of change required at the company level and to then implement the selected adjustments.

The rate comparisons presented in the previous pages are based on information gross of individual employer deductibles. Estimates of premium level changes derived from filed rates differ somewhat from those actually charged. We believe that a comparison based on charged premiums is likely to generate a more realistic estimate of changes in insurance cost levels than would a comparison based on filed rates. However, it is noteworthy that the filed manual rate and charged rate indices on the prior page closely track each other. Furthermore, the manual rate index is not affected by changes in mix, whereas the charged premium index could be. Another factor to consider as part of any premium level comparison is the degree to which shifts in market share among insurers may affect the final results.

Charged rate levels vary, potentially significantly, among carriers. By way of example, data provided by the WCIRB indicates that the rates charged by SCIF in recent years have been somewhat higher than those of private insurers operating in the state. (Refer to exhibit below)




The implication of the differences presented above is that average premium charges for other carriers are currently running approximately 15% below SCIF. A comparison is presented on Exhibit IV.7. below.



It is not our intent to suggest that SCIF rates are inappropriate. The salient issue here is that charged rate levels vary among carriers. To the extent that employers are successful in switching to lower cost insurers, aggregate premiums in the state could decrease by an amount that exceeds the rate reductions filed by individual carriers.

There may be a number of reasons for the current differences in premium levels. The fact that a difference exists does not necessarily imply that SCIF premium rates are overstated. The factors we believe to be most relevant are summarized below:

- California does not maintain a traditional assigned risk plan residual market for accounts that have difficulty in securing coverage through the voluntary market. Instead, SCIF serves as carrier of last resort. As a result, a portion of the employers insured by SCIF are likely to generate underwriting results that are somewhat worse than average.

- SCIF covers a disproportionately large share of small accounts in the state. This is important because WCIRB data suggests that such accounts, in aggregate, tend to generate higher loss ratios (in relation to approved pure premium rates) than larger accounts. The following exhibit shows the relationship between the average loss ratio (for all policies) and the loss ratio for a particular policy size.

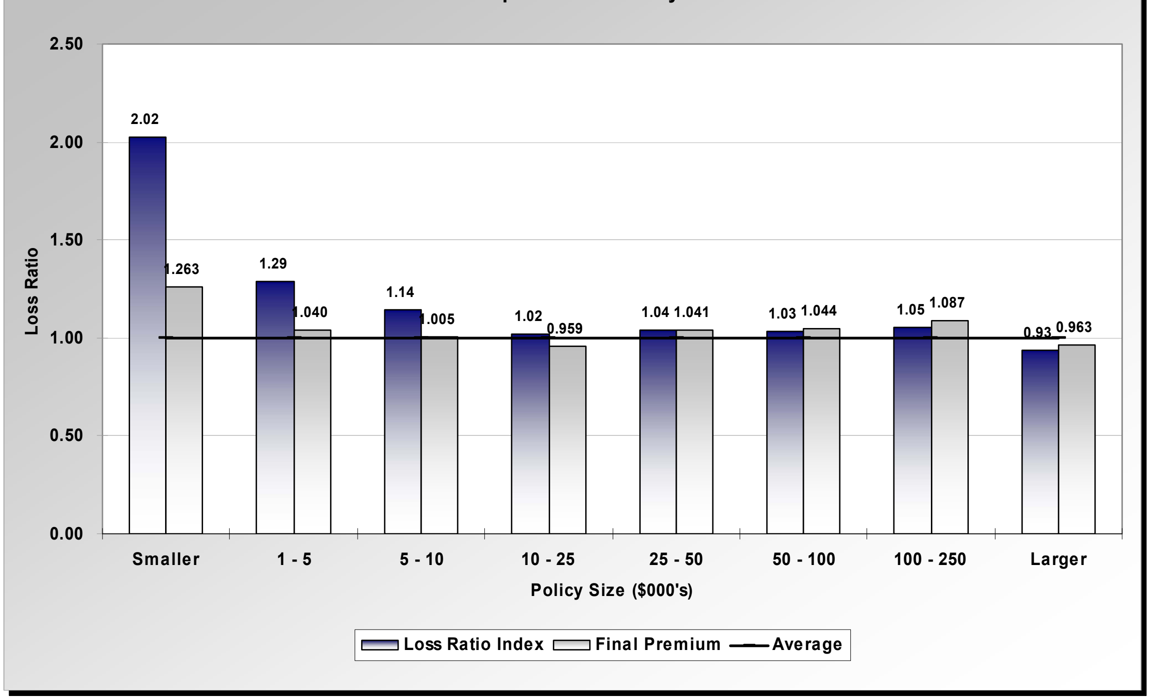



Exhibit IV.8. Relationship Between Policy Size and Loss Ratio

The graph above compares loss ratios by policy size at approved pure premiums to the average statewide loss ratio over a five year period. Historical loss experience suggests that small employers, as a group, tend to generate loss ratios that are roughly twice as high as the statewide average. Furthermore the indicated loss ratios tend to decline as policy size increases.

There is evidence that the pricing plans used by insurers in the state tend to reduce the loss ratio disparity shown above. In the following graph we add an additional set of loss ratio indices based on actual charged premium.

Loss ratio indices generated using final premiums display a much flatter distribution across policy size groupings than do the underlying pure premiums, suggesting that the rating plans may act to improve equity among employers.

The 2.02 figure for "Smaller" policies in the above exhibit means that on average, policies with $1,000 in premium or less generate loss and loss adjustment expense that is twice as high as the average for all risks. This supports the contention that smaller policies require higher rates.

## California Costs in Relation to Other States

The recent changes in pure premium and rate levels have had a significant impact on the relationship between workers' compensation costs in California and those in other states.

The "Workers' Compensation Premium Rate Ranking" report published by the Oregon Department of Consumer and Business Services provides a comparison of average filed manual rates as of January 1, 2004 for all fifty states, normalized to Oregon's class distribution.[1] Although the study is not directly applicable to California because of differences in the distribution of exposure by class, the tables contained in the report suggest that premium levels in California were the highest in the country. The Oregon study indicated that California rates at the beginning of 2004 exceeded those of Alaska, the state with the second highest rates, by almost 40%.

We prepared a comparison using filed pure premium rates (adjusted to exclude all loss adjustment expenses) in effect on January 1, 2006 and normalized to California's class distribution. The states included in the limited survey we completed were selected either because of geographic proximity to California or size. Some large states such as Pennsylvania and Washington were excluded because significant differences in the underlying classification plans used in those jurisdictions made comparison with California difficult.

The results, which are presented in the exhibit below, suggest that California has moved from its ranking as the highest cost workers' compensation environment in the country to a level that is more in line with those of other states. However, workers' compensation costs in the State remain higher than those of most other jurisdictions.

| Exhibit IV.9. Pure Premium Relationship to California – Percentage Higher or Lower<br>Approved Pure Premiums at January 1, 2006<br>Excluding Loss Adjustment Expense | | | |
|---|---|---|---|
| **Higher than California** | | **Lower than California-** | |
| **More than 25% Higher** | **Less than 25% Higher** | **Less than 25% Lower** | **More than 25% Lower** |
| Florida | Alaska | Minnesota | Arizona |
| Montana | Texas | | Colorado |
| | | | Hawaii |
| | | | Massachusetts |
| | | | Michigan |
| | | | Nevada |
| | | | New York |
| | | | Oregon |
| | | | Wisconsin |

*Note: Approved Pure Premiums in California have declined by more than 40% since July 2003.*

The above comparison is based on roughly 50 California classes which were selected to include more half of the statewide exposure at approved pure premium rates. A listing of the classes used in our comparison is presented as Exhibit IV.10. An exact matching with the California classes proved problematic due to differences in the class plans used in the surveyed states. California classes for which a straightforward comparison was not possible were excluded on a state-by-state basis. California payroll associated with the excluded classes did not exceed 10% of the targeted classes in any of the surveyed states.

The workers' compensation cost comparison among states is based on filed or approved pure premium levels (excluding all loss adjustment expenses), not final charged premiums. We acknowledge that the comparison is not exact, and that the relationship among states based on actual charged premium costs could differ from the listing presented above. However, we believe the comparison provides strong evidence that California has narrowed, but not eliminated, the gap in workers' compensation costs with most other states.

| Exhibit IV.10. Comparative Rate Index – Other States | | | | | |
|---|---|---|---|---|---|
| | | Weighted State | Equivalent California | Ratio to California | Percentage Higher or Lower |
| Alaska | AK | 2.04 | 1.71 | 1.19 | 19% |
| Arizona | AZ | 0.91 | 1.63 | 0.56 | -44% |
| Colorado | CO | 1.03 | 1.65 | 0.62 | -38% |
| Florida | FL | 2.18 | 1.71 | 1.27 | 27% |
| Hawaii | HI | 1.05 | 1.63 | 0.64 | -36% |
| Massachusetts | MA | 0.78 | 1.78 | 0.44 | -56% |
| Michigan | MI | 0.75 | 1.63 | 0.46 | -54% |
| Minnesota | MN | 1.28 | 1.65 | 0.78 | -22% |
| Montana | MT | 2.28 | 1.68 | 1.36 | 36% |
| Nevada | NV | 0.95 | 1.65 | 0.58 | -42% |
| New York | NY | 1.10 | 1.61 | 0.68 | -32% |
| Oregon | OR | 1.05 | 1.75 | 0.60 | -40% |
| Texas | TX | 1.73 | 1.62 | 1.06 | 6% |
| Wisconsin | WI | 0.93 | 1.63 | 0.57 | -43% |

# Chapter IV. Endnotes

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[1] Oregon Department of Consumer and Business Services; Workers' Compensation Premium Rate Ranking